INSIDE THE MINDS

Chapter 7 Commercial Bankruptcy Strategies

Leading Lawyers on Navigating the Chapter 7 Filing Process, Understanding Bankruptcy Trends, and Advising Clients

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Trustee Talk in Troubled Times: A Conversation about Commercial Chapter 7 Cases and the Role of Trustee's Counsel during the Great Recession

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Introduction

Generally, there are two types of commercial Chapter 7 cases. One is a converted Chapter 7, which is a Chapter 11 case that was filed and then fails for whatever reason and converts to a Chapter 7. The other type of case is a straight Chapter 7. Generally, there are just a few jurisdictions in which an attorney can have a thriving commercial Chapter 7 trustee practice. The Southern District of New York and Delaware are among the select venues with enough commercial asset cases worthy of prosecution that can support development of a mature Chapter 7 practice. Fortunately, I have been able to develop my niche commercial Chapter 7 liquidation practice in Delaware.

Recent Trends in Chapter 7 Commercial Bankruptcy

One of the biggest trends in commercial bankruptcies generally in the last few years is the use of Chapter 11 for the purpose of 363 bankruptcy sales. In a Chapter 11, the 363 sale typically occurs early in the case. Often there is a Chapter 7 conversion afterward. In some cases, sales are consummated, and then the case converts rather than confirmation of a Chapter 11 plan of reorganization. The resulting 363 sale usually leaves a corporate carcass after the key assets have been picked up. Another recent trend is cash-starved companies unsuccessfully trying to do a sale transaction. Such cases include a sale transaction in the Chapter 11 that failed and caused a conversion, or the debtor tried to do a sales transaction outside of bankruptcy and the financing was not there, the price was not right, or there was not enough support from secured lenders. That usually leads to a Chapter 7 filing because the business cannot survive without being able to close the sale.

I have had a couple of recent cases during which a company was forced to shut down and file for Chapter 7 because it was unable to consummate a proposed sale. Given the state of the economy, liquidity and access to financing are key to remaining solvent. Companies starving for cash are being forced to the bankruptcy altar sooner than they would like. Whether it is a sale they are failing to consummate, or they are running out of cash and need to shut off the lights, the lack of liquidity drives them into a Chapter 7 filing. This trend shows few industry favorites, and it is occurring across a broad swath of industries: suppliers, manufacturers, contractors, financial service companies, and health care firms. At times, a random, one-off company fails but that is not necessarily an indicator of a larger sector trend. For example, we were involved in a Chapter 7 of a Las Vegas nightclub with valuable equipment that we sold successfully, but that does not necessarily signal a tidal wave trend for the nightclub industry.

The Impact of the Great Recession on Chapter 7 Filings

The so-called Great Recession of the twenty-first century is the primary reason for the significant uptick in Chapter 7 filings. The Chapter 7 filings are often caused by liquidity crises due to lack of lender support. Unconsummated sales due to lack of liquidity on the part of the buyer can trigger a filing as well. Skittishness in forecasting can also affect bank support of the buyer. A bonding company pulling the plug may also diminish market interest in purchasing a construction company. This trend has worsened with the economy and the tightening of the credit market.

No doubt, the prime directive for trustees is to create an estate and create assets for distribution to creditors. The most critical way a bad economy impacts Chapter 7 cases is that asset buyers and defendants are in a weaker position themselves to fund sales and settlements. The impact of the economy with respect to hard asset sales is direct. The earlier example about the failed nightclub business is apt: the furniture, fixtures, and equipment (specialty audio mixing and foggers, for example) require a market for buyers to monetize the value of the equipment. The trustee will work with a sales agent/broker/remarketer or investment banker to test the market. Brokers must be able to tap into a market and find buyers. There are always bottom-fishers, but in this economy, they are harder to find.

In the Great Recession, trustees also tend to get less value for real estate assets. In another one of my cases, a failed industrial manufacturer owned valuable land. In a tightened real estate market, property values have obviously decreased. During the sale process, less competition forcing downward pressure deflates the sales price. If the trustee finds the right strategic buyer for any asset—as opposed to a financial buyer—it is possible to target the right niche and thus do well on hard asset sales. There are plenty of opportunities in this kind of market, and the sharpest players have the ability to create and maximize value. The key ingredient is a competitive process. The best way to maximize value is not just to find a buyer for the assets, but to locate multiple buyers and create an auction. This is the method by which a Chapter 7 trustee can best enhance value. An auction brings better results than confirming a sale to a solo stalking horse buyer.

The other key avenue that enables a trustee to discharge his or her fiduciary duty to maximize distribution is to create soft assets, including liquidation of accounts receivable, prosecuting pieces of litigation (including directors and officers suits), contract disputes, or special bankruptcy lawsuits such as preferences or fraudulent conveyances. The value of soft assets is also reliant on the economy, because defendants may have cash constraints and may be unable to pay settlements or judgments. A trustee may have great claims, but if there is not a viable company that can pay the judgment or settlement, it will be difficult to create a value based on the total of those soft assets or recoveries on lawsuits.

Successful Commercial Chapter 7 Strategies

Phase One: Address Secured Creditor Issues

The first order of business for a representing trustee is to evaluate the position of any secured lender and consider the validity, extent, and priority of its liens and applicable collateral. Assuming a typical situation where the lender has a blanket lien on all assets, counsel must determine whether the trustee and lender can work consensually to reach an agreement on a liquidation strategy that creates value for the estate, including carve-outs for professionals and brokers. The strategy should create incentives for the trustee to maximize value to the estate as a whole and provide a return to other creditors.

A Chapter 7 case is not supposed to benefit only the secured lender. It needs to benefit other creditors as well as provide a mechanism to liquidate the secured creditors' collateral. If collateral liquidation is the only goal, that can be accomplished in the context of a non-bankruptcy Article 9 sale. Therefore, a successful commercial Chapter 7 bankruptcy demands the determination as to whether a consensual liquidation agreement can be reached with the secured lender. Typically, if there is not an agreement, the secured lender will pursue a motion for relief from stay. Many times, the liquidation strategy can be made in conjunction with a trustee's objection to the stay relief. As an important first step, the two parties come together and work out a liquidation agreement.

If the secured creditor obtains relief from the stay and forecloses on the assets, all parties could be worse off, but often it is worst for the secured creditor—who may be the biggest loser. Obviously, it may also be bad for the trustee if he or she does not have assets to administer. However, the secured creditor has it worse, because it has a sunken investment it is trying to recoup. Failure to cooperate will likely yield far less return. The bankruptcy court and process put the trustee in a unique position to be able to maximize the value of collateral. Banks realize that, and they know they do not want to possess the collateral nor be in the position of liquidating it themselves. There are regulatory constraints on the way they have to handle collateral, and they have limitations on their ability to execute maximizing strategies. Often, a bank is better off cutting a deal with a trustee and allowing the trustee to liquidate. Once that is accomplished early in the case, it eliminates large and costly fights between the parties. This enables the parties to evaluate the collateral, determine the best way to set up a carve-out, and send it out on notice to all the creditors and ensure the court approves it.

Phase Two: Successful Liquidation

Once a liquidation agreement is approved, a Chapter 7 trustee can go about the business of conducting the liquidation, which occurs in multiple steps:

1. *Collect and secure critical information and hard assets.* This is the process of securing the premises, obtaining critical books and records in electronic or hard-copy form, and archiving the appropriate material so it is accessible for lawsuits, as well as securing valuable furniture, fixtures, and equipment, including vehicles and other hard assets.

2. *Minimize administrative claims.* There are always accruing administrative expense claims, such as rent from landlords and other expenses that include utilities. A trustee needs to secure hard

assets while minimizing administrative claims, dealing with secured creditors, minimizing their claims, and garnering and protecting the assets. In Delaware, in appropriate circumstances, a trustee is permitted to retroactively reject leases, provided that the property is surrendered to the landlord and that the landlord is provided notice of termination. This has a very big impact on the ability of a trustee to be able to successfully run a case. If a trustee has too many administrative claims, he or she cannot effectively administer the case. The concept and the picture of a successful Chapter 7 bankruptcy is when administrative claims are paid in full, a secured creditor is paid pursuant to their liquidation agreement, and there is money left to distribute to other creditors. If the trustee cannot generate enough funds to pay creditors beyond the administrative claim class, it is really not deemed successful from the perspective of the Chapter 7 trustee and the Office of the U.S. Trustee.

3. *Liquidate hard assets.* They take up physical space—which is not a benefit when there is a landlord clamoring for accruing rent. So the trustee needs to conduct a sale, auction, or quick transaction that minimizes lost opportunity costs for a landlord.

4. *Pursue litigation claims and soft assets.* Once the hard assets are gone and there is a bit more time and less administrative burn rate, the trustee can evaluate these claims. Sometimes there is a piece of litigation, such as typical commercial disputes, that has value, but the current assets of the estate are not sufficient to support the hourly rate of a lawyer to prosecute that litigation. In such cases, trustees often times look to hybrid or contingency-fee relationship with their counsel. In any event, the trustee must always determine when to settle and when to fight. It is his or her business judgment that is critical.

Overall, the key to a successful liquidation is recognizing those four points, responding quickly, and filing motions and getting heard on the immediate issues. If you cannot react quickly, there can be a tremendous amount of lost value in the first thirty to sixty days of the case due to administrative burn. A trustee has to get the physical assets removed from the premises and minimize costs. For a business with multiple locations and a number of physical assets with significant value, the trustee and counsel have to figure out a way to sell them quickly and limit the administrative exposure on rent and other costs. Often, rent can be highly disproportionate to the value of the assets that are contained within the space. It makes sense to pay rent when there are employees and equipment in use, but it does not make sense to pay full rent just for storage. Thus, speed is of the essence.

Phase Three: Claim Reconciliation, Distributions, and Final Report

The last stage of the case, depending on the assets available for distribution, would be claims analysis and objections, figuring out the claims of secured creditors, determining the claims of priority creditors and unsecured creditors to determine whether they are properly classified and in the proper amount, and filing the final trustee's report as the last document in the case. The final report is the disclosure to the court and to all interested parties of the assets, the creditors' claims, and what percentage on the dollar entities will receive. Once the court approves it, all the checks are then sent.

Keeping a Cool Head, Knowing When to Fight and When to Settle

The Chapter 7 process is not a "check the box" kind of process. The role of a trustee and trustee's counsel is to protect the creditors and maximize their return. To do that, counsel must be sensitive to the fact that many have previously been burned by the debtor. In fact, there is a great deal of emotion and anger in that situation. Unfortunately, the principals of the company, the management, and former employees who had the relationships and destroyed trust are gone. There is a third-party fiduciary, a Chapter 7 trustee. My role as counsel to the trustee is to ensure that the secured and unsecured creditors understand that the trustee and I are working as a fiduciary and trying to help them. We are on the creditors' team in the sense that we are trying to maximize the return and create an estate. The angst people feel should not be directed at the counsel or trustee. The reaction to that plea depends on the sophistication of the person hearing the request.

No matter how large the Chapter 7 filing, you always encounter the full gamut of people ranging in sophistication from extremely sophisticated and familiar with the Bankruptcy Code, to landlords who have real estate experience but do not have familiarity with bankruptcy, to small suppliers and individuals. The less-initiated folks may just know that they need to get paid and are trying to run a business, and they feel that they were burned as individuals. Employees who are owed wages typically know nothing about the process; in fact, they had the process forced upon them. It is extremely rare to not have that type of variety in a commercial Chapter 7 case. Even in a mega-liquidation, there would be a wide range of parties involved with varying degrees of sophistication. However, unlike Chapter 11 cases, Chapter 7 cases tend to be more streamlined and "bare bones" relative to the mechanisms used to deal with the different parties. As the lead bankruptcy lawyer for a trustee, I am on the front lines.

For example, I could be talking to a landlord who is concerned that there are physical assets on their property and they want to get them out, get assurance of payment, and check for future rent immediately or they will lock the doors. They may threaten to sue. The reality is that the administrative rent that accrues for those landlords after bankruptcy is on equal footing with my firm's fees. To the most recalcitrant folks, I explain that the ability of my firm to get paid is contingent upon the success of the estate. The landlord is incurring the same risk that my firm is. That puts the landlord at ease a bit, and they are less apt to feel singled out or asked to do things they do not want to do. When dealing with a creditor that is not connected to post-bankruptcy administrative expense but does have a claim, such as being owed money or wages, they tend to be less sympathetic to the argument. In these situations, I try to convince the party that the trustee and I are acting as a fiduciary trying to maximize value for them.

The Most Difficult Aspects of Chapter 7 Bankruptcy

The first stages are the most difficult, when there is a need for speed and getting the right players involved in the process. Obtaining contact information, leveraging competing interests and values and getting those parties to the table quickly, and cutting a deal that is reasonable to the estate, supportable to the court, and acceptable to the secured creditor are all critical steps. A carve-out situation is difficult because you have to move quickly and be certain you cut a deal that works and is reasonable. It must also include an appropriate discharge of fiduciary duties, and it has to get approved. That is not an easy process and is difficult to predict.

Often, you are estimating: the administrative claims, how much it is going to cost for the trustees' lawyers to do this work, how much it will cost for the trustees' accountants to do their work and required tasks, and what the broker needs to do.

Predicting all of the aspects of fixed costs while under a time crunch is not easy. Reminding people to not allow their emotions to get the best of them and stay focused on the task is equally tough. While we would like cooler heads to prevail, the compressed timeframe within which big decisions have to be made—often on the fly—demands the expertise of an experienced trustee. Lenders can tend to undervalue the benefit the trustee can provide, and may discount the costs associated with his or her involvement, but there must be a middle ground. Resolution becomes even more difficult if there is litigation underway at the same time. For example, if you are in the process of litigating a motion for relief from stay, you have to deal with that litigation at the same time as preparing a global liquidation agreement. Although many litigators deal with settlement and full-scale litigation at the same time, the difference here is that it is not just your settlement. In a typical commercial litigation, the one side wants X while the other side wants to pay zero. The solution in this situation is usually just to figure out 50 percent of X and settle. However, in a fight with the lender in a Chapter 7 scenario, you are dealing with a global liquidation agreement and settlement strategy that encompasses issues that are far more vexing than just how much of the pie is going to be split. Add the pressure of a very short timeframe when administrative fees are being incurred, employees are active, and there are disruptions at the beginning of the case, and you have a recipe for trouble.

Conclusion

Because of the Great Recession, we will continue to see more cases that are converted Chapter 11s and newly filed straight Chapter 7s. The bankruptcy docket is a lagging indicator, so even if the economy picks up in 2010, weaker companies may still need the services of a financial undertaker, because they are going to be the slowest of the herd. Therefore, even an uptick in the economy will likely not have a direct impact on the rate of filings in 2010. Chapter 7 filings will continue to increase, which will underscore the need for bankruptcy lawyers to move quickly, determine whether to "hold them or fold them," determine whether the case is worth administering, and structure deals expeditiously.

William J. Burnett is a shareholder in the financial restructuring, bankruptcy, and risk management group and a member of Flaster/Greenberg's executive committee. His practice involves representation in all areas of commercial Chapter 7 and Chapter 11 bankruptcy proceedings, creditor's rights, as well as corporate liquidations. His representations include Chapter 7 trustees, creditors' committees, Chapter 11 debtors, plan administrators, as well as various creditors, including secured and unsecured creditors, suppliers, landlords, equipment lessors, asset purchasers, and preference plaintiffs and defendants.

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